Internal Revenue Service

memorandum

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date: OCT 25

to: Assistant District Counsel
Newark, New Jersey

CN:NEW:TL
LJSpiegel

from: Tom Fuller Chief, Branch 6
Eric Turner Attorney-Advisor

subject: [redacted], Inc. - Extension of Period of Limitations for Assessment of Withholding Taxes

This responds to your memorandum dated June 28, 1990, requesting technical assistance on several issues pertaining to the period of limitations for the assessment of withholding tax on a withholding agent pursuant to § 1461.

Facts

The [redacted] Examination Division is currently examining [redacted], Inc.'s [redacted] calendar year income tax return. [redacted], Inc. (the taxpayer), is a U.S. corporation owned by [redacted]. During the audit, the taxpayer executed a Form 872 extending the period of limitations for assessment of "any Federal Income tax due on any return(s) made by or for the above taxpayer(s) for the period(s) ended . . . December 31, [redacted]" to December 31, [redacted]. At the time the Form 872 was prepared and signed, the agent was not aware of any potential withholding tax liabilities of the taxpayer. The examination has now produced a potentially large taxpayer withholding tax liability pursuant to § 1461 arising from an $[redacted] payment in [redacted] to [redacted], a [redacted] corporation. The payee provided the taxpayer with a completed Form 1001 (Ownership, Exemption, or Reduced Rate Certificate), exempting it from withholding on the basis that it was a trademark payment,[1] and no withholding occurred. The issues of whether the payee was, in fact, entitled to the withholding exemption and whether the taxpayer knew or should have known that the Form 1001 was false are currently under examination. The taxpayer, allegedly as the result of a clerical error, also failed to report the $[redacted] payment on its Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) or Form 1042S (Foreign Person's U.S. Source Income Subject to Withholding information return).

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[1] Article IX of the United States - [redacted] Income Tax Convention exempts royalties (including trademark payments) paid to a resident of a contracting state from tax by the other contracting state.

The technical assistance request contains the following questions:

1) Does a properly executed Form 872 for a domestic corporation also extend the period of limitations for assessment on the related Form 1042?

2) Is the six-year period of limitations for assessment under § 6501(e) applicable to a Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons?

3) Does a Form 1042 filed by a domestic corporation as withholding agent, which does not contain all Forms 1042S required by the regulations, constitute a return for purposes of § 6501(a) so as to start the running of the statute of limitations for assessment?

Discussion

A preliminary matter, which was cursorily referenced in the technical assistance request, pertains to the taxpayer's acceptance of the Form 1001 submitted by [redacted] If [redacted] is entitled to the treaty exemption, the taxpayer has no withholding liability under §1461. See Casanova v. Commissioner, 87 T.C. 214 (1986). The taxpayer is liable for the § 1442 withholding tax pursuant to § 1461 only if it had "reason to know" that [redacted] was, in fact, not entitled to the claimed treaty exemption and then failed to withhold. Rev. Rul. 76-224, 1976-1 C.B. 268 (withholding agent held not liable for withholding tax on interest payments to foreign banks because agent did not have reason to know that foreign banks were not entitled to exemption.) Accordingly, the above issues relating to the period of limitations for assessment are relevant only if the taxpayer is ultimately liable for the withholding tax pursuant to § 1461; hence, for discussion purposes, we will assume that the taxpayer is liable, i.e., had reason to know that [redacted] was not entitled to the claimed treaty exemption and still failed to withhold.[2]

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[2] If the Form 1042 filed by the taxpayer is fraudulent, the withholding tax liability imposed by § 1461 can be assessed at any time. § 6501(c)(1) If the taxpayer accepted [redacted]'s Form 1001 even though it knew that [redacted] was not entitled to the claimed treaty exemption and then fraudulently omitted this transaction from the Forms 1042 and 1042S, the applicability of the fraud exception to the period of limitations for assessment is clear. If, however, the taxpayer had no reason to know that [redacted] was not entitled to the claimed treaty exemption and the subsequent omissions on the Forms 1042 and 1042S were, as claimed, the result of a clerical error, the fraud exception would not be applicable.

Question 1 - Form 872

The primary inquiry appears substantial enough to have been the subject of previous consideration; unfortunately, there is nothing directly on point. The language of the Form 872 in question extends the taxpayer's period of limitations for assessment with respect to "any Federal Income tax" for the taxable year in issue. Does this language include a withholding tax liability imposed on the withholding agent pursuant to § 1461?

It is our conclusion that a Form 872 extending the period of limitations for assessment of "Federal income taxes" includes the withholding tax imposed upon withholding agents pursuant to § 1461 because the tax is an income tax. Several bases support this conclusion.

1. The withholding tax imposed by §§ 1441 and 1442 is clearly an income tax in that the amount of tax is directly determined by reference to the amount and type of income and also corresponds with the underlying tax provisions of §§ 871 and 881. The liability of a withholding agent pursuant to § 1461 merely reflects the agent's control, receipt, custody and payment of the income items; hence, the agent's liability is also function of the amount and type of income, albeit calculated on the basis that it is the payee's income as opposed to the withholding agent's.

2. This conclusion is supported by the U.S. Tax Court's recognition that the tax imposed on a withholding agent pursuant to § 1461 is an income tax. In S-K Liquidating Co. v. Commissioner, 64 T.C. 713 (1975), which held that the Commissioner could issue separate statutory notices for income and withholding taxes for a single taxable year not withstanding § 6212(c)'s prohibition against issuing multiple statutory notices for a single taxable year, the Court examined a withholding agent's liability for tax pursuant to § 1461. The court stated that "the tax is an 'income tax' in that it is imposed under chapter 3 (Withholding of Tax on Nonresident Aliens, etc.) of subtitle A (Income Tax)." 64 T.C. at 718

3. Finally, as noted by the Court in S-K Liquidating Co., this conclusion is arguably supported by the fact that the withholding tax imposed by §§ 1441 and 1442 and the liability for such imposed upon withholding agents pursuant to § 1461 are part of the Code's Subtitle A, which is labeled "Income Taxes". But see § 7806(b) (no inference is to be drawn from a section's location within the Code).

Our conclusion arguably conflicts with G.C.M. 39686 (12/11/87), which held that the addition to tax imposed pursuant to § 6661(a) can not be applied to a withholding agent who

substantially understates the tax liability on the agent's Form 1042. Section 6661(a) generally provided[3] for a 10 per cent penalty for a "substantial understatement of income tax". The G.C.M. concluded that § 6661(a) did not apply to a withholding agent's Form 1042 because its liability pursuant to § 1461 was not an income tax. A prominent rationale for this conclusion was that the legislative history accompanying § 6661(a) did not support imposing the penalty on a withholding agent. Although not specifically mentioned in the G.C.M., this conclusion is supported by case law requiring strict construction of both revenue and civil penalty provisions against the government. See Sutherland Stat. Const. §§ 59.03 and 66.01 (1986).

Should the Service choose to litigate this issue, we are in a favorable procedural posture. In the recent case Schulman v. Commissioner, 93 T.C. 623 (1989), which held, inter alia, that a transmittal letter forwarding a Form 872-A could not alter the terms of the Form 872-A, the court set forth the procedural nuances attendant to a taxpayer's claim that a statutory notice was not mailed within the applicable period of limitations for assessment and stated:

> Petitioner has made a prima facie case by showing that the notice of deficiency was mailed more than 3 years after his return was filed or due to be filed. Sec. 6501(a) and (b)(1). Under these circumstances, the burden of going forward with evidence shifts to respondent. Robinson v. Commissioner, 57 T.C. 735, 737 (1972). Respondent has satisfied his burden by showing that the parties executed a written consent extending the period of limitations on assessment (sec. 6501(c)(4)), and that the notice of deficiency was mailed prior to the extended period. Adler v. Commissioner, 85 T.C. 535, 540-1 (1985). Where, as here, the consent is valid on its face and petitioner asserts that it is restricted or invalid as to certain issues, **petitioner is again charged with the burden of going forward and affirmatively showing the invalidity of the written consent.** Crown Williamette Paper Co. v. McLaughlin, 81 F.2d 365 (9th Cir. 1936); Concrete Engineering Co. v. Commissioner, 19 B.T.A. 212 (1930), affd., 58 F.2d 566 (8th Cir. 1932). 93 T.C. at 638-9 (emphasis added).

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[3] In 1989, P.L. 101-239, Sec. 7721(c)(2) repealed § 6661(a), effective for returns originally due after [redacted]. This provision was replaced by § 6662, which provides for accuracy-related penalties, and includes, inter alia, substantial understatements of income tax.

Accordingly, at trial, [redacted] would bear the ultimate burden of going forward and affirmatively showing that the completed Form 872 extending the period of limitations for assessment of all Federal income taxes for the taxable year in issue does not include the tax imposed on withholding agents pursuant to § 1461. The underlying issue of law must, however, be decided favorably to the Service if we are to prevail on this matter.

Notwithstanding G.C.M. 39686, the determination that the tax imposed on withholding agents pursuant to § 1461 is an income tax for Form 872 purposes is the correct result. In addition to the rationales discussed above, another consideration pertains to administrative convenience. Although clearly it would be more prudent for examiners with potential withholding issues to complete the Form 872 for "all Federal income taxes (including withholding taxes)", the agent, as in the instant case, may simply be unaware of any potential withholding tax liability when the Form 872 is prepared; hence, it is not surprising that no specific mention of withholding tax is made in the Form 872. Although agents should be specifically instructed to reference both types of tax in the Form 872, our conclusion would alleviate difficulties arising from any oversights. Accordingly, our conclusion is both legally defensible and enhances administrative convenience.

Question 2 - Applicability of § 6501(e)

The second technical inquiry concerns whether the six-year period of limitations for assessment of tax under § 6501(e)(1) is applicable to a withholding agent and his Form 1042. Subject to the exceptions contained in § 6501(c), § 6501(e)(1)(A) generally provides:

> If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.

O.M. 20124 (2/4/88), whose author also prepared G.C.M. 39686, specifically considered this issue and concluded that the six-year period of limitations for assessment of tax does not apply to a withholding agent and its Form 1042. The primary rationale for this conclusion was that the legislative history of this section intended that this provision apply to a taxpayer's omission of gross income required to be shown on its return while a withholding agent's Form 1042 merely lists payees and their respective incomes.

The conclusion and rationale of O.M. 20124 appear correct; hence, we cite it with approval. Given that this answer deprives the Service of an extended period of limitations for assessment of tax, which is an important arrow in our enforcement quiver with respect to ensuring that withholding agents fulfill their withholding obligations, (b)(5)(DP) [redacted].

Question 3 - Valid Return

The final question pertains to whether a Form 1042 which lacks a required Form 1042S constitutes a return to start the period of limitations for assessment for § 6501(a) purposes.

Section 1.1461-2(b)(1), Income Tax Regs., requires withholding agents to file Forms 1042 on an annual basis. Section 1.1461-2(b)(2), Income Tax Regs., requires original copies of relevant Forms 1042S to be attached to and summarized in the Form 1042.

Blount v. Commissioner, 86 T.C. 383, 386 (1986), held that a Form 1040 lacking a required W-2 is a return starting the period of limitations for assessment. In reaching this decision, the Court reiterated a prior summary of relevant decisions by the Supreme Court and stated:

> The Supreme Court test to determine whether a document is sufficient for statute of limitations purposes has several elements: First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury.

Further, quoting Justice Cardozo in Zellerbach Paper Co. v. Helvering, 293 U.S. 172, 180 (1934), the Court also stated that:

> Perfect accuracy or completeness is not necessary to rescue a return from nullity, if it purports to be a return, is sworn to as such * * *, and evinces an honest and genuine endeavor to satisfy the law. This is so though at the time of filing omissions or inaccuracies are such as to make amendment necessary.

When these standards are applied to the immediate situation, the relevant question then becomes why was the Form 1042S omitted from the Form 1042? If the omission was, as claimed, an inadvertent clerical error, the Form 1042 is a return for § 6501(a) purposes. If, however, the omission of the Form 1042S was not the result of "an honest and genuine endeavor to satisfy the law," then the underlying Form 1042 may not constitute a

return for § 6501(a) purposes; hence, the period of limitations for assessment will not begin and the tax can be assessed at any time. § 6501(c)(3) Similarly, if fraud was involved in the filing of the Form 1042, the period of limitations for assessment also will never end.[4] § 6501(c)(1) Accordingly, additional factual development of this issue is necessary before we can definitely resolve this issue.

[4] There is, of course, a difference with respect to the underlying burdens of proof concerning these issues in that a more stringent standard accompanies the [redacted] issue.